

ORIGINAL

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EX PARTE OR LATE FILED

November 1, 2002

**RECEIVED**

Marlene H. Dortch  
Secretary  
Federal Communications Commission  
445 12<sup>th</sup> Street, SW  
Washington, DC 20554

NOV - 1 2002

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

Re: Ex Parte in CC Dockets 01-338, 96-98 and 98-147

Dear Ms. Dortch:

On October 31, 2002 I met with Robert Pepper, Chief of the Office of Plans and Policy, and Simon Wilkie, the Commission's Chief Economist.

The purpose of this meeting was to discuss the effects of the FCC's current network unbundling requirements on network investment. The attached material was reviewed during the course of this meeting.

I am filing this notice and the accompanying attachment and request that you associate this notice with the records of the proceedings listed above.

Sincerely,

*Robert T. Blau*

Attachment

cc: Robert Pepper  
Simon Wilkie

No. of Proceedings  
Listed Above

044

## Why UNE-P Will Undermine Network Investment, Service Quality, and Facilities-Based Competition in Local Exchange Markets

AT&T keeps promising to transition from UNE-P to a facilities-based entry strategy if regulators will just accede to its seemingly endless parade of demands (slash hot cut costs, eliminate commingling ban, require electronic loop provisioning, etc.) In reality, though, securities analysts already have figured out that AT&T will continue to slash investment for the rest of the decade, preventing it from transitioning from UNE-P to a facilities-based competitive strategy.

- Loop Capital Markets estimates that even though AT&T's operating revenue will decline at an average annual rate of -0.5% between 2003 and 2010, net income is projected to increase by nearly 18% per annum. This is due largely to a 5.9% reduction in annual depreciation expenses that results from a 10% cut in annual capital expenditures, and a -7.4% decline in interest expenses that results from using increases in free cash flow to buy down debt. *See Attachment A.* (Free cash flow refers to the difference between a company's earnings before interest, taxes, depreciation, and amortization (EBITDA) and the capital expenditures it needs to make to stay in business.)
- With no top-line (revenue) growth, projected cuts in capital expenditures that AT&T may need to make to generate 18% earnings growth will effectively preclude the company from "weaning" itself off UNE-P as a platform for offering local service to consumers. These projections further imply that AT&T will use operating income derived from deeply discounted UNE-P rates to help underwrite the capital expenditures it does make in serving its larger business customers.
  - Loop Capital Markets believes AT&T will cut its annual capital outlays from \$3,740M (10.8% of revenue) in 2003 to \$1,700M (5.1% of revenue) in 2010. *See Attachment A*
  - By comparison, from 1996 thru 2001, AT&T's annual capital expenditures (including its cable networks) averaged \$10,026M or 20% of its operating revenues.
  - Thus, by 2010, AT&T's annual capital expenditures may amount to less than one fifth of annual capital expenditures the company made between 1996 and 2001 partly in response to rapid growth of Internet and wireless traffic that occurred during the late 1990s.

From a network investment standpoint, the practical effects of UNE-P are decidedly negative for the ILECs as well as AT&T and other UNE-P CLECs. To the degree that these effects preclude local and long distance carriers from making the capital improvements needed to accommodate on-going growth in traffic requirements, UNE-P could contribute to service quality problems going forward.

- Loop Capital Markets projects that AT&T's capital expenditures on its consumer services will amount to a mere 1.1% of its consumer revenues over the entire 2003-2010 period vs. 9% for AT&T's business services. *See Attachment A*

- By comparison, FCC ARMIS data indicates that before the current “boom to bust” cycle in network investment got underway in 1996, the ILECs routinely spent about 20% of their annual revenues on capital refurbishments/improvements that are needed to keep network capabilities in sync with customer needs. See *FCC ARMIS Reports*
- Carrier capital spending forecasts recently published by Credit Suisse First Boston indicate, however, that capital outlays by all service providers, including the ILECs, over the next **5** years are expected to fall well below historical norms (e.g., 20% of revenues). See *Attachment B*
- Prospects that ILECs and other facilities based carriers may be forced to cut their capital budgets by another 30% or more as a result of earnings and cash flow being squeezed by UNE-P, a weak economy, and wireless substitution also has prompted several securities analysts to question whether all of this will produce “fewer services, more network outages, and crummier customer service.” See *Attachment C*

## Attachment A

### The New AT&T (\$ Millions)

Segment	2003	2004	2005	2006	2007	2008	2009	2010	ACGR
Business Services									
Revenue	\$26,367	\$26,566	\$26,831	\$27,100	\$27,372	\$27,644	\$27,920	\$28,200	1.0%
Operating Costs	\$22,880	\$22,979	\$23,076	\$23,306	\$23,539	\$23,774	\$24,011	\$24,252	0.8%
EBIT	\$3,487	\$3,587	\$3,755	\$3,794	\$3,833	\$3,870	\$3,909	\$3,948	1.8%
EBITDA	\$7,929	\$8,102	\$8,184	\$8,266	\$8,348	\$8,432	\$8,516	\$8,601	1.2%
CapEx	\$3,600	\$3,200	\$2,800	\$2,600	\$2,200	\$2,000	\$1,600	\$1,600	-10.9%
Free Cash Flow	\$4,329	\$4,902	\$5,384	\$5,666	\$6,148	\$6,432	\$6,916	\$7,001	7.1%
CapEx % of Rev	13.7%	12.0%	10.4%	9.6%	8.0%	7.2%	5.7%	5.7%	
EBITDA Margin	30.1%	30.5%	30.5%	30.5%	30.5%	30.5%	30.5%	30.5%	
Consumer Services									
Revenue	\$5,641	\$6,996	\$5,867	\$5,393	\$5,352	\$5,405	\$5,459	\$5,514	-6.2%
Operating Costs	\$6,289	\$5,060	\$4,225	\$3,882	\$3,853	\$3,891	\$3,931	\$3,970	-6.4%
EBIT	\$2,352	\$1,936	\$1,642	\$1,511	\$1,499	\$1,514	\$1,528	\$1,544	-5.8%
EBITDA	\$2,471	\$2,001	\$1,678	\$1,543	\$1,552	\$1,568	\$1,584	\$1,600	-6.0%
CapEx	\$100	\$80	\$80	\$560	\$60	\$60	\$60	\$60	-7.0%
Free Cash Flow	\$2,371	\$1,921	\$1,598	\$1,483	\$1,492	\$1,508	\$1,524	\$1,540	-6.0%
CapEx % of Rev	1.2%	1.1%	1.4%	1.1%	1.1%	1.1%	1.1%	1.1%	
EBITDA Margin	28.6%	28.6%	28.6%	28.6%	29.0%	29.0%	29.0%	29.0%	
Corporate Overhead									
Operating Costs	(\$400)	(\$400)	(\$400)	(\$400)	(\$400)	(\$400)	(\$400)	(\$400)	0.0%
EBITDA	(\$400)	(\$400)	(\$400)	(\$400)	(\$400)	(\$400)	(\$400)	(\$400)	0.0%
CapEx	\$40	\$40	\$40	\$40	\$40	\$40	\$40	\$40	0.0%
AT&T Corp	2003	2004	2005	2006	2007	2008	2009	2010	ACGR
Total Revenue	\$34,608	\$33,162	\$32,298	\$32,093	\$32,324	\$32,649	\$32,979	\$33,314	-0.5%
Gross Margin	50.0%	51.0%	51.0%	51.0%	51.0%	51.0%	51.0%	51.0%	
Gross Profit	\$17,304	\$16,913	\$16,472	\$16,367	\$16,485	\$16,651	\$16,819	\$16,990	-0.3%
CGS including Access	\$17,304	\$16,249	\$15,826	\$15,726	\$15,839	\$15,998	\$16,160	\$16,324	-0.8%
SG&A	\$7,614	\$7,129	\$6,943	\$6,901	\$6,950	\$6,896	\$6,926	\$6,996	-1.2%
EBITDA	\$9,690	\$9,784	\$9,529	\$9,466	\$9,535	\$9,755	\$9,893	\$9,994	0.4%
Dep. & Amort	\$5,576	\$5,422	\$5,156	\$4,887	\$4,600	\$4,273	\$3,958	\$3,653	-5.9%
Total Op Expenses	\$30,494	\$28,800	\$27,925	\$27,514	\$27,389	\$27,167	\$27,044	\$26,973	-1.7%
EBIT	\$4,114	\$4,362	\$4,373	\$4,579	\$4,935	\$5,482	\$5,935	\$6,341	6.4%
Interest Expense	\$2,320	\$1,895	\$1,702	\$1,664	\$1,620	\$1,552	\$1,465	\$1,359	-7.4%
Pre-Tax Inc from Operations	\$1,794	\$2,467	\$2,671	\$2,915	\$3,315	\$3,930	\$4,470	\$4,982	15.7%
Taxes	\$807	\$1,110	\$1,202	\$1,312	\$1,492	\$1,768	\$2,012	\$2,242	15.7%
Tax Rate	45.0%	45.0%	45.0%	45.0%	45.0%	45.0%	45.0%	45.0%	
Preferred Dividends	\$139	\$132	\$130	\$112	\$98	\$98	\$99	\$99	-4.7%
Net Income	\$848	\$1,225	\$1,339	\$1,491	\$1,725	\$2,063	\$2,360	\$2,641	17.6%
EBITDA	\$9,690	\$9,784	\$9,529	\$9,466	\$9,535	\$9,755	\$9,893	\$9,994	0.4%
less CapEx	\$3,740	\$3,320	\$2,920	\$2,700	\$2,300	\$2,100	\$1,700	\$1,700	-10.7%
equals Free Cash Flow	\$5,950	\$6,464	\$6,609	\$6,766	\$7,235	\$7,655	\$8,193	\$8,294	4.9%
CapEx as % of Rev	10.8%	10.0%	9.0%	8.4%	7.1%	6.4%	5.2%	5.1%	
Discounted Cash Flow	2003	2004	2005	2006	2007	2008	2009	2010	ACGR
EBITDA	\$9,690	\$9,784	\$9,529	\$9,466	\$9,535	\$9,755	\$9,893	\$9,994	0.4%
Taxes	\$807	\$1,110	\$1,202	\$1,312	\$1,492	\$1,768	\$2,012	\$2,242	15.7%
CapEx	\$3,740	\$3,320	\$2,920	\$2,700	\$2,300	\$2,100	\$1,700	\$1,700	-10.7%
w/k Cap Increase	(\$424)	(\$49)	(\$61)	(\$1)	\$13	\$14	\$15	\$15	
Cash Flow	\$4,719	\$5,305	\$5,346	\$5,453	\$5,756	\$5,900	\$6,197	\$6,067	3.7%
DCF Market Value									
Discount Rate	10%								
Terminal Value Growth	3%								
PV of Cash Flow	\$29,330								
PV Terminal Value	\$21,668								
DCF EV	\$50,999								
Less Net Debt	\$34,046								
Equity Value	\$16,953								
Shares Outstanding (Mill)	3,800								
Estimated Value Per Share	\$4.46								

Source: Greg Gorbatenko, CFA, CPA, CMA. Loop Capital Markets 27 Sept 2002

## Attachment B

(\$ in millions)	2001A	2002E	2003E	2004E	2005E	2006E	5-Yr CAGR 2001-2006
<i>Local Exchange</i>							
<i>Carriers</i>	\$29,392	\$18,500	\$15,000	\$15,501	\$16,516	\$18,146	-9%
<i>CLECs</i>	4,458	1,500	600	500	400	300	-42%
<i>IXCs</i>	39,105	12,800	11,500	11,842	12,134	12,511	-20%
<i>ISPs</i>	2,290	1,000	600	600	500	400	-30%
<i>Cable Companies</i>	17,338	14,800	12,500	11,875	12,172	12,902	-6%
<b>U.S. Total</b>	<b>92,583</b>	<b>48,600</b>	<b>40,200</b>	<b>39,958</b>	<b>41,340</b>	<b>43,839</b>	<b>-14%</b>
<b>Year-over-year growth</b>		-47.5%	-17.2%	0.7%	3.3%	5.4%	

<b>Regional Bell Company Capital Intensity Ratios</b>	<b>2002E</b>	<b>2003E</b>	<b>2004E</b>	<b>2005E</b>	<b>2006E</b>
<i>Cap Ex as a % of Sales</i>	17.8%	14.3%	14.5%	15.0%	16.0%
<i>Cap Ex per Access Line</i>	\$128	\$101	\$103	\$107	\$116

## Attachment C

### Excerpts from Telecom Securities Analyst Reports That Address UNE-P

*From "SBC Communications: 2Q Delivers Improving Sequential Trends," Blake Bath, Lehrman Brothers, July 24, 2002.*

#### **Recip Comp All Over Again?**

On the regulatory side, the current rapid acceleration of Consumer UNE-P deployment by the IXCs looks, smells and feels a lot like the regulatory gaming employed by many CLECs several years ago with reciprocal compensation (note how many CLECs remain in the recip comp business). It also seems to fly in the face of the spirit of the 1996 Telco Act and relies on below-market costs that are not specifically defined in, or protected by, the Act. The basic premise of the 1996 Telco Act was to encourage robust competition in telecom services markets through the entrance of non-traditional carriers facilitated by regulatory-protected means of access to existing RBOC local assets in the near term, and eventual progression to more full facilities-based provision longer term as technology advancements and scale building **allow** (w/ packet networks and alternative broadband last-mile access etc). *Clearly the intent of the Act was not to create a subsidy that would effectively go exclusively into the hands of the two dominant incumbent long distance carriers* who have not, and clearly do not intend to invest capital in the business.

Rather, the idea of UNE-P was to create a near-term acceleration of opportunity for new carriers, to get them "over the competitive hump" until they could ultimately invest in their own efficient infrastructure, which would ultimately benefit end users.

However, it has become clear that neither AT&T nor MCI intend to invest in alternate consumer local infrastructure, but rather to play the regulatory arbitrage in states that set low UNE-P rates. Ultimately, we believe the FCC will eliminate the UNE-P system, using either the triennial review or its response to the recent Eighth Circuit court ruling as a vehicle.

We believe the FCC recognizes the disincentive to investment that is being created for the RBOCs (as we live through yet another quarter of CAP spending cuts, and their impact through the various technology industries), and recognizes that there are numerous other facilities-based consumer vehicles for narrowband and broadband communications (note the numerous \$35-\$40 per month all-you-can-eat wireless offers, and many cable companies offering telephony and high speed internet access.)

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*From "How Much Pain from UNE-P.?", John Hodulik, CFA. et al, UBS Warburg LLC, August 20, 2002,*

Our analysis shows that UNE-P rates in 18 states do not allow the Bells to generate positive EBITDA on lines lost to competitors. Meanwhile, the capital intensity of the business is largely unaffected by the retail/wholesale residential line mix, suggesting free cash flow will suffer. For every \$1 in revenue lost to UNE-P based competition, we estimate the Bells lose \$0.70-0.85 of EBITDA and \$0.45-0.60 of after-tax operating cash flow (EBITDA less capex).

As there is no avoided capital cost in the conversion of retail lines to wholesale, the after-tax free operating cash flow impact would be roughly \$1.2 billion. Because of these underlying trends, the carriers are likely to double their cost-cutting efforts.

We find the regulatory outcome to be most difficult to project...an outcome that removes uncertainty surrounding UNE-P regulation and leaves the economics intact may encourage new entrants and accelerate retail line loss for the Bells.

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*From Scott Cleland, Precursor Group, testimony before the Subcommittee on Telecommunications Trade & Consumer Protection, May 25, 2002.*

By leap-hogging the actual stage of competition, and assuming a competitive price, the FCC has undercut the incentive to compete with an overbuild. Why overbuild if one can lease it more cheaply than one can build it? We strongly suspect that the success of the UNE-P resale will adversely affect the incentive for facility-based competition.

By applying forward-looking pricing methodology (TELRIC) to the entire service by inventing an unbundled element platform (UNE-P), the FCC effectively bypassed the Telecom Act's intended 10-20% effective wholesale discount with a manufactured 50% effective wholesale discount. This was the FCC's plan to accelerate resale competition.

However, the unintended consequence of the FCC's strategy has been to effectively devalue all infrastructure investment by everyone, incumbents and competitors alike, whether it is fiber, cable, or fixed wireless.

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*From "Telecom Regulation Note: FCC to Re-examine Unbundling and Line Sharing." Anna-Maria Kovacs, Ph.D., CFA, et al, Conimcrce Capital Markets. May 28, 2002.*

[The] ILECs are likely to have less incentive to invest when they have to share their facilities at prices below true cost and that CLECs have less incentive to invest when they can make the ILEC carry all the risk. The DC Circuit does not accept the FCC's argument that both CLECs and ILECs have built facilities since passage of the 1996 Act: "The question is how such investment compares with what would have occurred in the absence of the prospect of unbundling, ...an issue on which the record appears silent."

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*From "SBC: Reduction of Wholesale Rates in California Negative for Bells," Jack Grubman. Salomon Smith Barney, May 17, 2002.*

Yesterday, the California Public Utilities Commission ordered SBC/Pacific Bell to reduce wholesale rates it charges competitive carriers by 42%, on average.

The consequences of the CPUC decision on wholesale rates for SBC in California (or SBC's Pacific Bell division) is that SBC gets 40% less revenue for UNE-P customers in California although costs may actually be greater to serve UNE-Ps given fixed costs associated with serving the line plus the additional cost for setting the UNE-P as a wholesale line. This could have other implications for other Bells in the nation as other states may further

reduce wholesale rates. In January of this year, the New York PSC reduced wholesale rates by 30% on average.

Another impact of UNEs is on line growth. UNEs skew access line growth because typically UNEs are used to serve residential customers, thus the Bells would lose a residential line. However, wholesale lines are included in switched business lines. Thus, UNE-P dampens residential line growth but artificially inflates business line growth. The problem for the Bells is that UNEs, since they are included as business lines and carry only 60% of residential line revenues (which are already less than half of the average business line revenue) reduces the ARPU's, although costs to serve these lines may actually increase.

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*From "The Status of 271 and UNE-Platform in the Regional Bells' Territories," Anna Maria Kovacs et al, Commerce Capital Markets, May 1, 2002.*

The trend in UNE pricing is clearly downward. At this point, it appears likely that the price of the full UNE platform (UNEP) will be in the \$15-25 range in most states by the time the 271s are done. That represents not only a hefty discount from average revenue, but from cost as reflected on the financial books, as well

The RBOCs' cost structure is almost entirely fixed over the short term and nearly fixed even over a one or two year horizon. We do not believe that an RBOC which leases out a UNEP line is able to save any of its cost, other than the cost of generating the bill. In fact, as RBOCs struggle to deal with churn and to regain customers, their total costs may well **rise**. Consequently, their financial cost per subscriber is **likely** to rise even as their UNE prices are forced down.

Given the current anxious state of the financial markets, reduced earnings growth forecasts could result in multiple compression. Actual earnings shrinkage, particularly if those declines are expected to be sustained long term, would further lower RBOC stock prices, and the declines could be severe.

[F]or all RBOCs, UNEs are priced below cash operating cost, and radically below total operating cost including depreciation and amortization. The discounts from total cost are 50%-60% below total cost even when total cost does not include cost of equity, a component that is allowed under TELRIC.

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*From "Telco Wake-up Call," Colette Fleming, CFA. et al, UBS Warburg, July 24, 2002*

What changed to make UNE-P such a prominent issue? Stale regulators have been seeking to increase competition and lower prices for consumers by lowering wholesale rates. RBOCs are forced to charge UNE-P competitors. We have seen large decreases in UNE rates in NY, NJ, IL, **CA** and other states. This has encouraged carriers such as MCI (WorldCom) and AT&T to enter the residential market – MCI through its Neighborhood plan in over 40 states, AT&T more selectively in six states where the discounts are unusually large.



Who are the winners? In the near-term, AT&T and WCOM should continue to take share in the local residential market. However, their longer term prospects are unclear. We believe the FCC, backed by the courts, is looking to curb the availability of UNE-P while promoting facilities-based competition through the Triennial Review, concluding in late 2002.

Who are the losers? The Bells should see increasing loss of lines in the near term. The conversion of a retail line to wholesale cuts the Bells' revenue per line by 40-50% with minimal reduction in the costs to provide service.

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*From "The Status of 271 and UNE-Platform in the Regional Bells' Territories," Anna Maria Kovacs et al, Commerce Capital Markets, August 22, 2002.*

For the CLECs, the lower UNE rates present the opportunity to enter the local market with minimal up-front investment.

From the RBOC-investor's perspective, UNE-P presents several problems. One is the reduction in revenues that comes from converting retail to wholesale revenues. The other is the pricing compression that comes from the RBOCs' own attempts to restructure their prices to compete with the new entrants.

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*From "SBC Communications Inc: Another Tough RBOC Quarter, Another Set of Estimate Cuts," Adam Quinton et al, Merrill Lynch, July 24, 2002.*

Revenue from the non-LD voice segment fell 7.7% YoY to \$6.3B in 2Q. Management attributed approximately **75%** of the seasonably adjusted revenue decline to retail lines lost to UNE-P based offers primarily from WorldCom's MCI unit and AT&T. The reduction was also due in part to continued wireless and Internet substitution, both of which have lowered consumer reliance on traditional wireline telephony and contribute to the secular factors we have discussed impacting the group, not just SBC.

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*From "SBC: Lowering Estimates, Price -Target." Frunk G. Louthan IV, et al, Raymond James & Associates Inc., July 24, 2002.*

Shifts from wholesale and retail to UNE-P lines threaten to reduce revenue generated per line provisioned in addition to margins on the local voice side of the business, with every RBOC readily admitting that UNE-P is priced below their cost.

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*From "SBC Communications -- SBC: 2Q: Good Cost Control But Weak Trends & Visibility," Jack Grubman et al, Salomon Smith Barney, July 23, 2002.*

UNE-P will be a negative factor on primary line growth for years – not months or quarters. Furthermore, we see almost no chance that UNE-P price reductions will reverse since this is a political windfall. **You** have AT&T and even MCJ still – two brand names aggressively marketing discounted local packages to consumers. There is not a politician in America who would go up against that trend.

From a Bell perspective, as we've written many times over the past several months, this is a nightmare. They get half the revenue with the same cost. **... It stands to reason that as UNE-P proliferates and cable telephony proliferates, things only get worse, not better for the Bells.**

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*From "BellSouth Corp -- BLS: Details on Weak 2Q'02 Results," Jack Grubman et al, Salomon Smith Barney, July 22, 2002.*

**We continue to believe that secular issues in addition to cyclical issues will weigh on RBOC performance. In other words, the Bells issues will not evaporate entirely with a healthier economy.** ... Today we are seeing broadband as a substitution for fax machines (cable modems winning over DSL) and wireless substitution instead of second or third wireline connections for teenagers and others in the household. In addition, competitors are using higher UNE-P discounts to resell local service. This shows up within the 3.5% decrease of residential primary retail access lines (to 13.67 million down from 14.16 million one year ago) and the 414% increase in residential wholesale UNE-P lines to 586,000 up from 114,000 in the year ago period.

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*From "Wireline Services: No Relief in Sight," Robert Fagin, et al, Bear, Stearns & Co., Inc., July 2002.*

The interexchange carriers (IXCs) are aggressively seeking lower UNE pricing to make further investment worthwhile. **AT&T has stated, for example, that it will not enter a new state with UNE-based service unless the gross margin is about 45%.** Other considerations IXCs take into account when offering UNE-based local service are the regulatory landscape for competitive local providers in the state and the upfront costs required to establish service. **We do not believe AT&T and WorldCom's UNE-based local services are profitable.** These services will become profitable as more customers are amortized over the cost base.

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*From "WorldCom Group -- WCOM: Z-Tel Meeting Suggests UNE-P May Have Some Legs," John Hodulik, CFA, et al, UBS Warburg, June 25, 2002*

In summary, we continue to see UNE-P as a short-term thorn in the RBOCs side, however, one that is likely to get worse before it gets better.

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*From "They Could Go All the Way," Vik Grover, CFA. et al, Kaufman Bros. Equity Research, October 1, 2002.*

UNE-P is Killing RBOC Profits

- CLEC buys all elements from RBOC – no cap-ex required except for backoffice
  - Focus on billing and service
  - UNEP line provide approx. 60% of revenue and 40% of gross profit compared to **retail** lines.
  - SBC – 2.5% loss of retail access lines in Q2. BLS – 1.8%.
  - 50% of losses made up in UNEP for SBC, almost 90% for BellSouth-tremendous growth at low end of market.
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*From "Telecom Services: UNE-P: the Un-Profitable RBOC," Bruce J. Roberts, et al, Dresdner, Kleinwort, Wasserstein Research. August 9, 2002.*

RBOCs' core profit center is under severe attack from competitive forces. Regulators have reduced UNE pricing such that CLECs are using UNE lines to penetrate the residential and small business markets. **In** our view, until UNE pricing becomes more rational, the RBOCs will suffer steeper profitability squeezes from CLECs using UNE lines.

Our view is that the current rules forcing RBOCs to resell local lines to CLECs at very deep discounts are off course. The goal of the 1996 Act was to create the environment for local competition, not create local competition. Although seemingly subtle, this is a huge distinction. The idea is that to produce new, exciting services and pricing programs requires a competitor to provide new, exciting services. How can that occur if the CLEC is reselling the RBOCs' service? ... In point of fact, the growth in resale (UNE resale) is accelerating, despite the fact that the base of CLEC customers is also expanding. With UNE, the CLECs are merely behaving as rational decision makers. If it's cheaper and **less** risky to resell rather than build, then resell is the answer.

According to the FCC, 55% of CLEC lines served medium and large businesses and government customers. In contrast, just 23% of ILEC lines served such customers. Conversely, 45% of CLEC lines served residential and small business markets, while over 75% of Bell lines served lower profit residential and small business lines. Businesses and government offices are more densely packed, and spend more per access line than residents.

Thus, the ILECs are left holding the "bag" – serving more of the costly (read: geographically dispersed) and lower paying line base. We view **the** "cream skim" as one of **the** most compelling arguments that local competition regulation is destructive and illogical.

From a macroeconomic point of view there are several concerns with the UNE-P system:

- **It's** a policy-stimulated transfer of wealth (from shareholders and employees to consumers), rather than being let **to** market forces.
- In the longer-term it could rob consumers **of** advanced services that require **the** RBOCs' plentiful cash flow to fund.
- Asset writedowns will cause "stock-shock" and a shock **to** the telecom "supplier" system.

The combination of very effective lobbying on the part of small and large (read: AT&T CLECs, and a democratic FCC (thought to be friendly to long distance and CLECs, not RBOCs) prodded the FCC to create the UNE-Platform ... In the short run, the consumer **wins** with these artificially lowered local rates. In the long term, the consumer **will** suffer as ILECs cut their capital budgets by 30%, **which** will produce fewer services, more network outages, and crummier customer service.

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*From “RBOCs Weak Yesterday on UNE-P Concerns,” Timothy Horan, CIBC DataTimes, August 21, 2002.*

Longer-term, the current UNE-P framework is unsustainable. There is no way that the RBOCs in a capital intensive industry with the high fixed costs can afford to sell their key input of production to their competitors at a steep discount and survive.

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*Note: Boldface type indicates emphasis added*